IN THE

Supreme Court of the United States

October Term, 1978

No. 78-606

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY,
Petitioner,

v.

THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, and ROBERT BATINOVICH, VERNON L. STURGEON, RICHARD D. GRAVELLE, CLAIRE T. DEDRICK, and WILLIAM SYMONS, JR., the members of said Public Utilities Commission, et al.,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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Pursuant to Rule 42(3) of the Rules of this Court, the Edison Electric Institute ("EEI") respectfully moves the Court for leave to file the brief *amicus curiae* annexed hereto. While Petitioner and Respondent Communications Workers of America have granted consent,[1] the other Respondents have refused to do so.

1. Copies of the consents have been filed with the Clerk of the Court. As of the date of this Motion, Respondent Toward Utility Rate Normalization has not responded to EEI's request for its consent.

Interest of *Amicus Curiae*

EEI is the national association of electric utility companies. Its members serve more than 99% of all customers of the investor-owned segment of the utility industry and about 77% of the Nation's electricity users. Among EEI's interests are the development nationally of sound policies and procedures for the establishment of rates and tariffs by regulatory agencies.

This case involves contrary interpretations of the Internal Revenue Code ("Code") by the Internal Revenue Service and a state regulatory commission. The Code provides for reductions in currently payable federal income taxes if two conditions are satisfied: one, a utility follows certain accounting procedures; and two, the utility's state regulatory commission adopts a consistent ratemaking treatment. For Petitioner, the accounting and ratemaking procedure is called "normalization", as specified by Congress. The California Public Utilities Commission ("Commission") claims that the ratemaking treatment it has ordered for Petitioner is "normalization", but the Internal Revenue Service has determined that it is not "normalization", and that, if the Commission's Decision is applied to Petitioner, Petitioner will no longer qualify for the reductions in current federal income taxes. The inconsistency thereby created subjects Petitioner to the loss of substantial federal income tax benefits and to enormous financial risk.

EEI members, like Petitioner, are subject to both federal and state regulatory jurisdiction. At the federal level, EEI members are subject to the policies established by Congress, including the provisions of the Internal Revenue Code. At the state level, EEI members are subject to the ratemaking authority of state regulatory bodies. The various states have provided differing accounting and ratemaking treatment of federal income tax expense, as was recognized by Congress when the current accelerated depreciation and Investment Tax Credit provisions were enacted.

The decision of the Commission is of great importance to the member companies of EEI because the Commission has made and is enforcing an interpretation of the federal tax laws contrary to the interpretation of the Internal Revenue Service.[2] The Commission has acted on matters which are reserved, in our federal system, for exclusive determination in the federal domain.

The decision of the Supreme Court of the State of California, in failing to review the decision of the Commission, appears to leave the Commission free to interpret the Internal Revenue Code in a manner at odds with the interpretation of the Internal Revenue Service. This result is of substantial importance not only to Petitioner, which has very large sums at risk from the Commission's Decision, but also to EEI's members. Petitioner has referred to $218,000,000 as the amount of its deferred federal income taxes in 1977. The income statements of EEI's members for 1977 showed amounts of deferred federal income taxes resulting from liberalized (accelerated) depreciation and the Investment Tax Credit aggregating in excess of $2,000,000,000. EEI Statistical Year Book, EEI Pub. No. 78-3, at 62. Estimates of the corresponding deferred amounts for 1978, by EEI's members, approach $3,000,000,000.

Adoption of the stated rationale for the Commission's decision by other regulatory agencies will imperil the continued eligibility of taxpaying public utilities for benefits specifically made available by Congress in the Internal

2. The Commission's September 13, 1977 Decision is unreported as yet, but is set forth at App. B, pp. 3A-74A of the Joint Appendix filed herein by Petitioner.

Revenue Code.[3] In the area of federal taxation, national uniformity is of particular importance, yet it is threatened by variable and inconsistent determinations by state regulatory bodies. The disregard for the requirements of federal law evidenced by the actions of the Commission, if emulated by other state regulatory bodies, will make a shambles of the Internal Revenue Code, contravene the Supremacy Clause of the Constitution and, indeed, shake the very foundation of our federal system.

EEI, as a national association, holds a position from which it can meaningfully present the national importance of the issues herein and their relationship to the regulation of utility rate tariffs. Taking a broader view than is normally available to the individual parties, the annexed brief *amicus curiae,* in addition to endorsing the arguments of Petitioner, demonstrates the unmistakable Congressional intent in having determinations of eligibility for federal tax law benefits made at the federal level and not usurped by state regulatory bodies.

3. The Commission's Decision may be read by regulatory bodies in other states as precedent for such bodies to apply their own differing interpretations of the Internal Revenue Code to those EEI members subject to their jurisdiction.

Conclusion

For the reasons stated above and in the annexed brief, EEI requests leave to file the annexed brief *amicus curiae* in support of the petition for a writ of certiorari.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF CALIFORNIA

BRIEF OF EDISON ELECTRIC INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Edison Electric Institute ("EEI") supports the petition of The Pacific Telephone and Telegraph Company ("Pacific") for a writ of certiorari to review the judgment of the Supreme Court of the State of California in *The Pacific Telephone and Telegraph Company* v. *The Public Utilities Commission of the State of California, et al.,* 21 Cal. 3d, Official Advance Sheets, No. 21, minutes, p. 3 (1978). In that decision, the California Supreme Court refused to review Decision 87838 ("the California Deci-

sion") issued on September 13, 1977 by the California Public Utilities Commission ("Commission").

Interest of *Amicus Curiae*

The interest of *amicus curiae* is set out in the motion for leave to file, which is bound together with this brief.

Statement

The Commission proceeding considered the ratemaking treatment of federal income taxes as affected by Pacific's use of accelerated depreciation and the Investment Tax Credit ("ITC") as provided in §§ 167 and 46(f) of the Internal Revenue Code ("Code").[1] Both accelerated depreciation and ITC are available to reduce the federal income taxes actually paid during the years in question provided that specified ratemaking procedures are followed. The Commission specifically found that Pacific's continued eligibility for these provisions was "an important goal of this Commission in this decision" (47A):

> In the final analysis *a loss of eligibility to the utilities would not only create service problems . . . but would create staggering financial problems to be ultimately borne by the ratepayers whose interests we are attempting to redress.* We believe that eligibility for these tax benefits should be maintained and proceed on this basis. (Emphasis added) (22A).

1. The Commission's decisions respecting the ratemaking treatment of federal income taxes in the 1970 and 1972 applications had been set aside by the California Supreme Court in *City and County of San Francisco* v. *Public Utilities Commission*, 6 Cal. 3d 119 (1971) and *City of Los Angeles* v. *Public Utilities Commission*, 15 Cal. 3d 680 (1975), respectively and remanded to the Commission for further consideration. The two remanded cases were consolidated with consideration of the federal income tax aspects of the 1975 rate application filed by Pacific (97A-99A). (Citations in the form of a number followed by "A" refer to the specified page of the Joint Appendix, as filed herein by Pacific.)

If Pacific's eligibility for these benefits is to be maintained, two conditions must be fulfilled. First, the utility must maintain its regulated books of account on a normalization basis. This Pacific has done.

Second, the state regulatory commission must employ "normalization" ratemaking consistent with §§ 167 and 46(f) of the Code.[2] This is the heart of the present controversy. The Commission has independently defined normalization under the Code, and required Pacific to act in accordance with that definition. However, the Internal Revenue Service ("IRS") has ruled that the Commission's definition is inconsistent with the Code. Accordingly, Pacific faces the dilemma of losing the tax benefits, and suffering grievous loss, because the Commission erroneously insists that it has the authority to interpret the Code in a manner inconsistent with the interpretation of the IRS.

The Commission recognized that the question of Pacific's eligibility for both accelerated depreciation and ITC was "a case of first impression under the tax laws" (40A). However, the Commission did not seek any determination from the IRS of whether the ratemaking treatment imposed by the Commission met federal requirements for continued eligibility. The Commission also refused to stay its Decision pending determination by the IRS of Pacific's continued eligibility.[3]

Pacific thereupon sought, and obtained, rulings from the IRS respecting Pacific's continued eligibility for accelerated depreciation and ITC under the ratemaking ordered by the

2. See Petition at 5-6; 11A-12A.

3. This failure led to strong dissents by Commissioners Symons (71A) and Sturgeon (73A).

Commission.[4] These rulings determined that Pacific would not be eligible for the tax benefits because of the ratemaking treatment being applied.

While the majority of this state commission stalwartly maintains that the Commission has provided for Pacific's eligibility at federal law, two of the three Commissioners comprising the majority entered a concurring opinion acknowledging the need for prompt review by this Court:

> The *ultimate* verdict on the validity of this decision will have to be made in the United States Supreme Court and the sooner that is accomplished the better off all participants will be. (Emphasis in original) (70A).

This Court should grant certiorari to correct the wrongs against the Petitioner and to permit the achievement of a specified Congressional purpose. If the Commission's Decision is allowed to stand, the Commission may in the future attempt to apply the same, or equally improper, regulatory ratemaking methods to electric companies. Moreover, other state agencies and participants in rate proceedings will be given the signal that they can interpret and frustrate the requirements of federal law with impunity.

4. Two rulings on the issues raised by Pacific were ultimately issued by the IRS, one on June 8, 1978 (95A-115A) and the other on July 27, 1978 (133A-142A). Since Pacific's appeal to the California Supreme Court was pending at the time the first ruling was received, a copy of that IRS determination was lodged with the California Supreme Court.

ARGUMENT

I

The California Commission, By Reason of the Supremacy Clause of Article VI, Lacks the Authority to Interpret the Federal Tax Laws In a Manner Not Consistent With an Internal Revenue Service Interpretation.

California's Decision attempts to establish, absent IRS review or consent, the eligibility requirements for accelerated depreciation and ITC available under the Code. In so doing, the California Commission invades an exclusive domain of the federal government and attempts to avoid giving effect to Congressional policies underlying these eligibility requirements. Moreover, despite the obvious need for national uniformity in this area, i.e., a single arbiter of the meaning of the Internal Revenue Code, California has arrived at conclusions that have been found by the IRS to be contrary to the requirements of the controlling federal law and regulations. This interference in an area that is preempted by the federal government has produced a grave federal-state conflict (which will continue if this precedent is allowed to stand). California's action is contrary to the Supremacy Clause of Article VI.

A. Congressional Intent

The reasons underlying Congress' authorization of accelerated depreciation and ITC are discussed in the Petition.[5]

Two aspects deserve emphasis. First, a primary motivation for both of these provisions was Congress' intent[6] to

5. Petition at 4-8.

6. See H.R. Rep. No. 83-1337, 83rd Cong., 2nd Sess. 24 (1954); H.R. Rep. No. 92-533, 92nd Cong., 1st Sess. 23-26 (1971).

stimulate capital investment. For public utilities, the normalization ratemaking required by Congress provides more internally generated capital, in furtherance of this policy. Second, Congress made an explicit determination to restrict the future availability of these provisions to utilities regulated on a normalization basis, so as to hold the resulting reductions in utilities' taxable income, and hence taxes payable to the federal government, within limits.[7]

B. The California Decision

The California Decision indicates both an awareness of, and a dissatisfaction with, the means chosen by Congress to further the policies behind the accelerated depreciation and ITC provisions of the federal tax laws.[8]

The Commission stated that these statutory provisions have forced "everyone involved in setting rates to go through a series of contortions and distortions to attempt to comply with or legally avoid the effect of the existing tax laws. . ." (45A). In the California Decision, these "contortions and distortions" have taken the form of an attempt to redefine normalization accounting and the eligibility requirements for accelerated depreciation and ITC.

Despite the novelty of the accounting method ordered by the California Commission,[9] the Commission casually assumed that its method would meet the requirements of the federal tax laws and be consistent with an IRS determination.[10] The Commission also failed to provide for any safe-

7. H. R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-176 (1969).

8. 12A, and see the "Epilogue" to the Decision (43A-45A) and Finding 17 (48A).

9. See 40A.

10. See 49A-50A.

guards in the event the IRS disagreed, safeguards which are necessary to avoid dire consequences to Pacific and its customers in the event the IRS decision differed.

C. Preemption

The well established legal standard for preemption[11] was repeated in this Court's decision just last term in *Ray v. Atlantic Richfield Company*, 435 U.S. 151 (1977). While certain aspects of federal endeavor touch upon elements of this standard, federal taxation is the very purse string of the federal government and manifests preemption in a mature and fully developed fashion. The criteria established by this Court, case law, and the Code's legislative history clearly support the conclusion that the California Decision intrudes improperly into matters reserved for federal determination.

There can be no doubt that federal tax statutes are pervasive, and delineate specifically the eligibility requirements for accelerated depreciation and ITC.[12] In fact, the legislative history of these statutes indicates that Congress was specifically aware of the efforts of regulatory agencies to avoid implementing the policy objectives underlying these laws.[13] Accordingly, Congress mandated specific forms of ratemaking treatment of accelerated depreciation and ITC in order that eligibility be maintained. These statutory provisions are supplemented by the regulations issued by the Treasury Department further prescribing the neces-

11. See, e.g., *Rice* v. *Santa Fe Elevator Corporation,* 331 U.S. 218, 230 (1947).

12. See Petition at 5-8.

13. See H. R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 131-132 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 171-172 (1969).

sary conditions for eligibility.[14] In the face of this legislative history, California should not enter this area of pervasive and specific federal regulation by construing Petitioner's eligibility for certain federal tax benefits inconsistently with the IRS.[15]

The need for dominance of the federal interest in this area of regulation is apparent. The California Decision, if upheld, would hamper Congress' ability to use the tax laws to effectuate critical national economic policy goals and to assure a continued and stable flow of revenues to the federal treasury.

By its very nature, interpretation of federal tax law requires national uniformity. Our unified system of federal taxation is predicated on a structure whereby the authority to interpret the various provisions of the tax laws is vested in one, and not many, regulatory bodies. The Internal Revenue Service alone has the primary authority to determine the meaning of the federal tax laws and the eligibility requirements contained therein.

The approach followed by California could potentially fragment this authority and disperse it to numerous state

14. See Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) § 1.167(1).

15. See *Burnet* v. *Harmel*, 287 U.S. 103 (1932); and ***Helvering*** v. *R. Douglas Stuart*, 317 U.S. 154, 161 (1942). In a case involving a conflict between a state regulatory commission and the Federal Power Commission, a federal court prohibited the state commission from interfering with actions of the federal regulatory agency. *Federal Power Commission* v. *Corporation Commission of the State of Oklahoma*, 362 F. Supp. 522 (W.D. Okla. 1973), ***aff'd*** 415 U.S. 961 (1974). The Court said: "The unequivocal language of the Orders shows that the Oklahoma Corporation Commission is ***dissatisfied*** with the Federal Power Commission's producer rate regulation and that Defendant would, therefore, ***like to substitute its judgment for that of the Plaintiff*** [*Federal Power Commission*] *regarding such rates* . . . It is obvious that the Orders in question would circumvent Plaintiff's [Federal Power Commission] regulatory jurisdiction." (Emphasis added) 362 F. Supp. at 537-38.

regulatory bodies in addition to the Internal Revenue Service. As a result, taxpaying utilities are put in an impossible position. Rates set on the basis of a state commission's assumptions of the existence of federal tax benefits are not reasonable when the controlling federal agency, the IRS, concludes that the tax benefits will be terminated as a result of the state commission's decision.

Clearly, this is an instance where a state seeks to frustrate Congressional intent in an area of paramount federal authority. California's Decision cannot be allowed to stand.

D. Direct Conflict

This Court recently reaffirmed the rule that state action is unconstitutional if it conflicts in fact with federal law, even where Congress has not exclusively occupied an area. *Ray* v. *Atlantic Richfield Company, supra.*

In the instant controversy, Pacific is in the middle of a direct conflict between federal and state regulation, each regulator pulling in opposite directions. Pacific is either eligible for accelerated depreciation and ITC or it is ineligible; it cannot be both simultaneously. The California Commission has declared that Pacific is eligible. The Internal Revenue Service has ruled that under the Commission's Decision, Pacific will be ineligible.

> The Commission said:
>
> The methods described in findings 3 and 4 maintain the eligibility of the utilities to use accelerated depreciation and ITC and comply with the requirements of the Internal Revenue Code relating to Pacific and General (49A-50A).
>
> The IRS said:
>
> [W]e believe that the Commission's annual average adjustment method is not a proper normalization method of accounting . . . Therefore, should the

> Commission's Decision No. X become final the taxpayer would no longer be eligible to use an accelerated method of depreciation . . . (113A).
>
> Accordingly, should Decision No. X of the Commission become a final determination pursuant to section 46(f)(4) [of the Code], we believe that its application for the adjustment of rates in years subsequent to the test year would be inconsistent with the requirements of section 46(f)(2) and would result in Pacific's . . . loss of eligibility for the investment tax credit under section 38.[16] (142A).

The conflict brought about frustrates the objectives of Congress. The IRS has determined that Congressional policies underlying the tax laws will be obstructed if the California Decision is not reversed.[17] The Decision boldly announces its disagreement with these policies and an intention to attempt to reach a result consistent with the law while frustrating to the maximum extent possible the underlying federal policy.[18]

Federal taxation is an area in which Congress has provided a pervasive scheme of regulation. The subject matter is one requiring uniform, national interpretation at the federal level. The Supremacy Clause requires that the state regulation must give way.

16. The interpretations of the Internal Revenue Service are to be accorded great weight since "[t]he construction of a statute by those charged with its execution should be followed unless there are compelling indications that it is wrong." *Beal* v. *Doe*, 432 U.S. 438, 447 (1977); *New York Dept. of Social Services* v. *Dublino*, 413 U.S. 405, 420 (1973).

17. 112A-113A, 142A.

18. 43A-45A.

II

The Action of the California Commission Constitutes a Violation of Substantive Due Process.

Certiorari should be granted because the action of the California Commission is an arbitrary and capricious denial of substantive due process under the Fourteenth Amendment of the Constitution. The Decision made no provision which would allow Pacific a reasonable opportunity to secure a ruling from the Internal Revenue Service on the issue of eligibility. The Commission's failure to incorporate this simple safeguard in its Decision was described by Commissioner Symons as "reckless" and by Commissioner Sturgeon as "cavalier".[19] Pacific has been placed at a totally improper, and unnecessary, risk. To date, the Commission's Decision is the final word, since that Decision controls the federal tax treatment available. However, unless this Court itself resolves the underlying issue of the propriety of the Commission's Decision, it will be impossible to determine whether the California Commission's interpretation is right or wrong. In the meanwhile, no

19. Commissioner Symons, dissenting, said: "California stands to lose at least a billion dollars, with nothing to gain, as the Public Utilities Commission majority again plays brinkmanship with the United States Government. There is no need to recklessly risk eligibility for such enormous sums in federal tax deferrals and federal tax forgiveness. . . . I cannot support a decision which fails to take the opportunity to resolve the 'eligibility' issue before the Commission decision is finalized and 'set in concrete'" (71A). Commissioner Sturgeon, dissenting, said: "The inconsistent and cavalier manner in which the majority treats the key issue of eligibility . . . warrants my strong dissent. . . . After recognizing and elaborating upon the importance of eligibility, the majority then, incredibly, moves quickly to jeopardize that eligibility by adopting a regulatory accounting scheme whose compliance with the standards of normalization established by the Internal Revenue Code and Treasury Regulations *must* be considered a matter of speculation" (Emphasis in original) (73A).

protection is given to Pacific. If this Court does not act, the ultimate determination will follow the tax assessments by the Internal Revenue Service many years in the future and Pacific will be compelled to pay out enormous amounts which it stands no chance of recovering.

EEI believes that the Due Process Clause requires the California Commission to treat Pacific in accordance with basic principles of fairness. These basic principles of fairness mandate that the Commission provide for (as distinguished from merely recognizing) the possibility of a conflicting IRS determination on eligibility by establishing some procedure either to maintain the *status quo* pending an IRS determination or, if permissible under state law, to undo the damage resulting from its order in the event the IRS denies eligibility.

It has long been the rule that the arbitrary exercise of power by the States is prohibited by the Due Process Clause. *Hurtado* v. *California,* 110 U.S. 516, 528, 532, 536 (1884). In *Atlantic Coastline Ry. Co.* v. *North Carolina Corporation Commission,* 206 U.S. 1, 20 (1907), the Court said that wherever the power of regulation is exerted in such an arbitrary and unreasonable way as to be, in effect, not regulation but an infringement on the right of ownership, such an exertion of power is repugnant to the Due Process Clause.

The Court has also overturned administrative action which it found to be "an exercise of arbitrary power, at variance with 'the rudiments of fair play' . . . long known to our law." *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio (No. 1),* 294 U.S. 63, 71 (1935); *Interstate Commerce Commission* v. *Union Pacific R.R.,* 222 U.S. 541, 547-8 (1912).[20] The Court's discussion of the limitations

20. *See also Morgan* v. *United States,* 304 U.S. 1, 22 (1938) where Chief Justice Hughes, speaking for the Court, said: "agencies . . . must accredit themselves by acting in accordance with the cherished judicial tradition embodying the basic concepts of fair play."

upon state legislative actions in *Day-Brite Lighting, Inc.* v. *Missouri,* 342 U.S. 421, 423 (1952) shows that substantive due process is a vital antidote to remedy extreme actions that reach beyond constitutional bounds and conflict with the requirements of federal law.[21]

This is an extreme case. The state regulation challenged herein is manifestly arbitrary, capricious and unreasonable. One may fairly inquire whether it was adopted only for the purpose of questioning and challenging the federal regulatory scheme established by Congress, rather than incident to the purpose of implementing utility rates.[22]

The issue of eligibility is of enormous importance to Pacific and its customers. In view of the express recognition that the case is one of first impression under the federal tax laws (40A), basic fairness and plain common sense point to the need for safeguards to protect Pacific in the event that an IRS determination conflicts with the interpretation of the Commission. The Commission's refusal to provide these safeguards fails to meet minimal standards of due process required by the Constitution.

21. *North Dakota Pharmacy Bd.* v. *Snyder's Stores,* 414 U.S. 156, 164-167 (1973); *Ferguson* v. *Skrupa,* 372 U.S. 726, 731-732 (1963); *Williamson* v. *Lee Optical Co.,* 348 U.S. 483, 488 (1955).

22. See, Concurring Opinion by Commissioners Gravelle and Dedrick (70A). In the Epilogue to its Decision, the Commission said: "This Commission believes that it has a legal duty to balance the interests of the utilities and the ratepayers and is attempting to do so, but finds itself more frequently hamstrung by the actions of Congress where it appears that the interests of the utility ratepayers are not adequately considered for whatever reason" (44A). In the body of its Decision, the Commission stated: "This horrendous result has been created by Congress through the options allowed the utilities in the tax laws, which have the effect of allowing the regulatee to regulate the regulator" (12A).

Conclusion

For all of the reasons stated above, Edison Electric Institute believes that this Court should grant the writ of certiorari requested by The Pacific Telephone and Telegraph Company.

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